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INFLUENCE OF FINANCIAL LITERACY ON PERFORMANCE OF SMALL AND MEDIUM ENTREPRISES: A CASE OF BUTERE SUB COUNTY KAKAMEGA COUNTY KENYA.

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Abstract

The desire by governments all over the world to improve the standard of living of their citizens has led to growth in the number of small and medium enterprises (SMEs). In Kenya, economic growth forms one of the pillars to attaining vision 2030 whose aim is to enhance the quality of living standards of Kenyans. However, the success of the SMEs is dependent upon a number of factors. A key ingredient in ensuring sound performance of SMEs is the level of financial literacy of the business people. The study aimed at assessing the influence of financial literacy on performance of small and medium enterprises. The objectives of the study were to evaluate the influence of budgeting skills, record keeping skills, credit management skills and tax compliance skills on performance of small and medium enterprises. The target population of the study was 3,916 consisting of the SMEs business community in Butere sub county, Kakamega County, Kenya. A sample of 390 was used in the study. The study employed a descriptive research design. Stratified random sampling was used in identifying the respondents. Data was collected using structured questionnaire. Regression equation was used to analyze the collected data. The study found out that financial literacy has a significant impact on the performance of SMEs. The study recommends that the government and non-governmental organizations should facilitate training of business people in the sector of SMEs so as to equip them with the necessary financial literacy skills in order to spur economic growth.

***Key words**: Financial literacy, Performance, SMEs, Credit management, Tax compliance.*

1.0 INTRODUCTION

The term small and medium enterprise (SMEs) is used worldwide though there is no common definition due the geographical placement of SMEs as well as country specific legislation (Leopoulos, 2006). SMEs have in the recent past emerged as key instruments of realizing both economic and social development in the developing countries. Over the last two decades, scholars and policy makers in both developed and developing countries have recognized that entrepreneur financial literacy is critical for the establishment and survival of small businesses (Wise, 2013). The performance and growth of SMEs has throughout the nations been of great concern to among others development economists, entrepreneurs, governments, venture capital firms, financial institutions and non-governmental organizations (Eniola & Entebang, 2014). The interest in SMEs has been attributed to their potential in creating employment and contribution to gross domestic product (GDP) of the country. SMEs form a large part of economy and are regarded as the drivers of socio-economic development in all countries. In OECD countries, over 95% of all enterprises fall in the SME category, while over 50% of the private sector employment is supplied by SMEs (Lukacs, 2005). In Turkey, the significance of SMEs is relatively higher, which is caused by not only their large share, amounting to 99.9% of all formally declared businesses in the economy, but also from their resilience to the shocks in turbulent Turkish macro economy (Karadag, 2015). This trend has also been witnessed in other European countries. In Africa the role played by SMEs cannot be over emphasized. Kenya cannot afford to ignore the importance of SMEs, being one of the developing countries with a rapidly

expanding youth population. The sector contributes 20% of the gross domestic product and provides goods and services, promotes creativity and innovation, and enhances entrepreneurial culture (Economic Survey, 2013). In recognition of this role, the Government enacted the Micro and Small Enterprise (SME) ACT (GoK, 2012) aimed at providing an enabling policy and legal environment for SMEs. The economic pillar of Kenya's Vision 2030 identifies SME development as a key strategy to propelling the country to a middle income economy by the year 2030 through equity and poverty elimination. It aims at significantly reducing the number of people living in absolute poverty to the smallest proportion of the total population. At macroeconomic level, small businesses are the backbone of many economies and when the financial literacy skills among entrepreneurs are not sufficient to operate successful enterprises, the whole economy is at risk (Dahmen & Rodríguez, 2014). The performance of SMEs is highly dependent on the skills and knowledge of the owner- managers of these enterprises. This can be measured by the level of financial literacy of these entrepreneurs. Financial literacy relates to the capability to adequately manage financial resources over the life cycle of a business and to effectively connect with financial products and services (Gavigan, 2010). Financial literacy is the degree to which one understands important financial concepts and possesses the capacity and confidence to appropriately handle personal funds for purposes of decision-making in both short term and long-term (Remund, 2010). The aspect of financial management in SMEs is often different to that found in large firms. This is attributed to fact that large firms have a more dynamic nature of cash flow cycle, general paucity of working capital, and ability to raise finance through debt or equity. In addition SMEs lack the financial management and accounting systems available to large firms, as well as the professional staff who manage such systems (Mazzarol, 2015). Normally the owner-manager performs all the tasks, with the help of a bookkeeper in some cases. This is a pattern found throughout the world, both within the advanced economies that comprise the Organisation for Economic Co-operation and Development (OECD) group of nations, and the developing economies (Amoako, 2013; Uwonda *et al.*, 2013).

1.1 Statement of the Problem

There is general consensus that SMEs play a pivotal role in social-economic development of any country. To this end many countries have put in place measures to encourage business people to initiate and sustain small and medium enterprises. However, not all the business ventures have attained the desired level of success. Some scholars have argued that there is a direct linear relationship between entrepreneur financial literacy and performance of microenterprises (Capuano, 2011). In Kenya, financial literacy has not received the attention it deserves. Only a few studies have been carried out around this topic despite its importance. (Njoroge, 2013) found out that majority of entrepreneurs in Kenya suffer from weak levels of financial literacy, limited access to financial services and high transaction costs. Ongesa et al (2014) evaluated the impact of financial literacy on loan repayment by small and medium entrepreneurs in Ngara and found that financial literacy training improves loan repayment among the small and medium business owners. However, the impact of financial literacy on the general performance of the SMEs was not explored. This study therefore investigated the impact of specific financial literacy constructs on the performance of SMEs.

1.2 Objectives of the study

The general objective of the study was to assess the influence of financial literacy on performance of SMEs. The specific objectives were as follows:

i. To evaluate the influence of budgeting skills on performance of SMEs
ii. To measure the influence of record keeping skills on performance of SMEs
iii. To determine the influence of credit management skills on performance of SMEs
iv. To ascertain the influence of tax compliance skills on performance of SMEs

1.3 Significance of the study

Generally over the years, employment opportunities in the formal sector have been

dwindling. SMEs have emerged as an alternative form of employment especially to the youth and women. However this sector has previously faced challenges with some businesses closing down leading to great suffering to the affected parties. This study sought to measure the impact of financial literacy on performance of SMEs. The findings of the study are important in ensuring that SMEs are equipped with the necessary skills that guarantee their success hence contributing to job creation.

2.0 Literature Review

2.1 Theoretical framework

The study was based on three theories namely; financial literacy theory, stakeholders theory, and agency theory.

2.1.1 Financial literacy theory

The financial literacy theory is based on the financial management behavior of individuals. The theory posits that the behavior of individuals is guided by the dual-process theories that embrace the idea that decisions can be driven by both intuitive and cognitive processes (Evans 2008). Dual process theories have been applied to several fields, including reasoning and social cognition. Although dual-process theories come in many different forms, they all agree on two main distinguishing processing mechanisms. One of the processes can be characterized as fast, non-conscious, and tied to intuition (System 1), and the other as slow, controlled, and conscious (System 2), (Stanovich & West 2000). System 2 is responsible for analytical and rational thinking which is needed to consistently implement financially literate investment strategy. The acquisition of financial literacy empowers the business people with skills necessary for sound financial management. Such people are likely to follow a cognitive process of decision making.

2.1.2 Stakeholders' theory

The stakeholders' theory identifies four major stakeholder groups to include main shareholders, employees, customers, and the general public (Freeman, 1984). The support of the stakeholders is important in the achievement of the organizations' objectives. In general, a stakeholder is any individual or group that can affect or is affected by the prioritizing of the organizations' objectives. There are three forms of stakeholders' approaches, namely descriptive, normative, and instrumental stakeholder approaches (Jones et al, 1999). The descriptive approach emphasizes understanding the relationship between an organization and its stakeholders while the normative approach emphasizes that organizations should take all stakeholders into consideration, as a moral responsibility. Stakeholders may bring an action against the directors for failure to perform the required duty of care (Freeman, 2004). This makes the theory relevant since SMEs do not operate in isolation. They interact with suppliers who expect prompt payment, customers who expect quality goods as well the government which expects adherence to set rules and regulations.

2.1.3 Agency theory

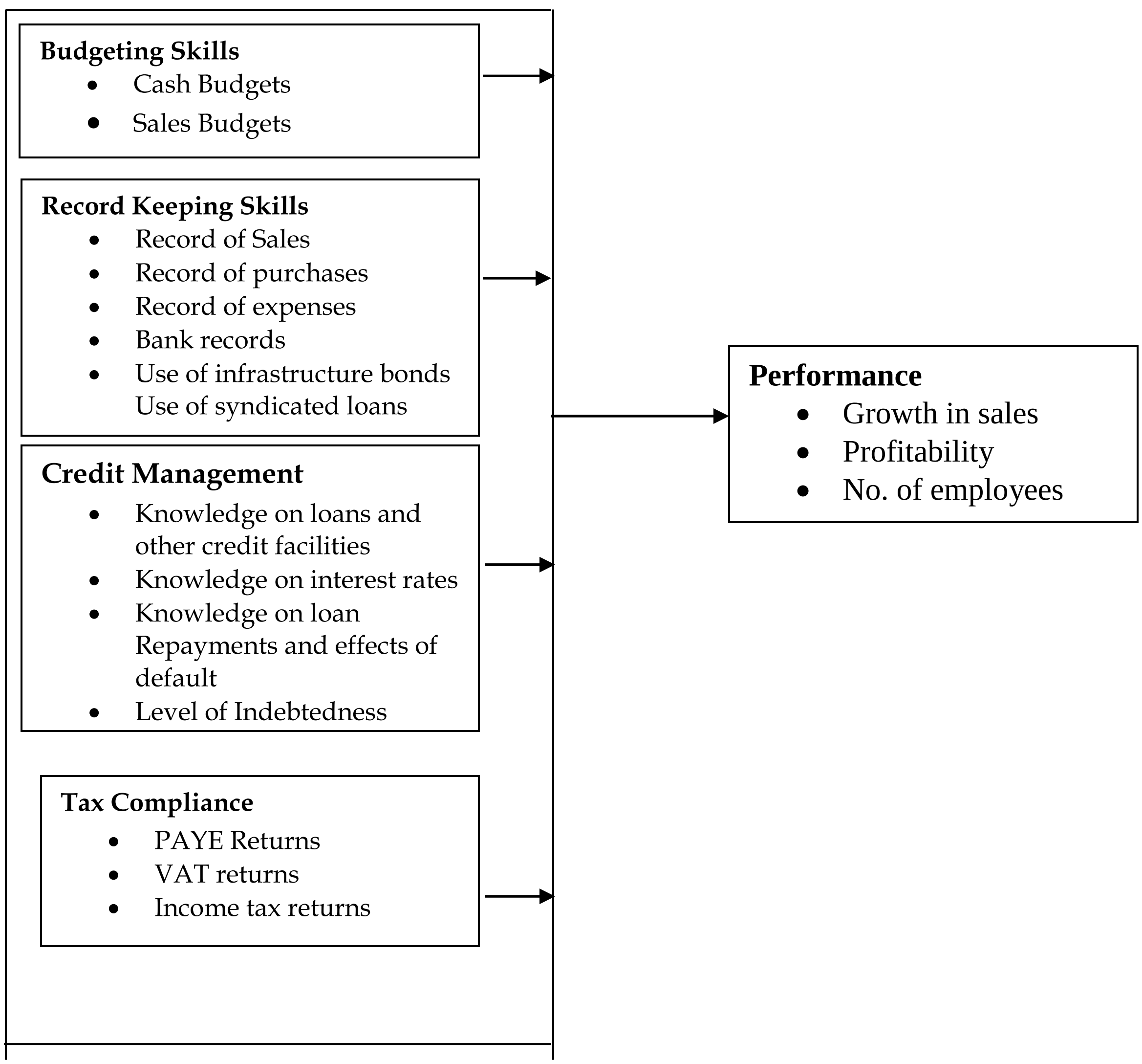
The main concern of agency theory is how to write contracts in which an agent's performance can be measured and incentivized so that they act with the principal's interests in mind (Jensen and Meckling, 1976). Agency theory is concerned with the conflicting interests of principals and agents (Laiho, 2011). The expansion of some SMEs necessitates employment of managers to run the business on behalf of the owners. The managers are the agents while the owners are the principals. In this case managers, who serve as owners' agents, are required to act in the owners' best interests. However, in most cases, managers' and owners' interests do not always converge. The managers may focus on a range of personal benefits at the expense of shareholders' interests. Such personal benefits may include higher compensation, additional incentives, job security and sometimes securing assets or cash flows (Tudose, 2012). This may eat into the profits available to the owners and ultimately, adversely affect performance of the SME. The owners may normally try to deter such value transfers by putting in place supervision, monitoring and control mechanisms. Another way of reducing agency costs of free cash flow and imposing discipline and efficiency is through leveraged buyouts (Stewart, 2001). Clear alignment of the agents' interest with

those of the owners will ensure increased profitability and growth of the SME.

2.2 Conceptual Framework

In this study four financial literacy constructs were identified. These formed the independent variables. The constructs were budgeting skills, record keeping skills, credit management skills and tax compliance skills. The influence of these constructs on performance of the SMEs was investigated.

Independent Variable **Dependent variable**



2.3 Budgeting in SMEs

The concept of budgeting relates to the expenditure planning and cash flow analysis (Uddin et al, 2009). This aspect is very important to the success of the business operation and processes (Bragg and Burton, 2006). It relates to making forecasts on essential aspects of the business. Such essential aspects of the business include estimating sales as well as cash requirements over a given period of time. Cash requirement budgeting entails estimation of income and expenditure over a given period. Accurate estimation of cash requirements will ensure that the business pays its liabilities as

they fall due to avoid any penalties as well as straining relations with suppliers. On the other hand, any excess cash would be invested wisely to increase the business profitability. It has been noted that budgeting skills acquired assist the entrepreneurs to increase their sales and business profitability by providing a basis of establishing performance targets (Siekei & Aquilars, 2013). Furthermore the budgeting skills contribute towards ensuring smooth running of the business. Ability to estimate sales ensures that sufficient inventory is held. Running out of inventory leads to less sales and loss of customers. On the other hand excess inventory leads to high holding costs like warehousing and insurance charges. In addition there will be capital tied up in the inventory which could otherwise be profitably invested.

2.4 Record keeping

Business transactions occur on day to day basis. It is therefore impossible for the business person to recall all these transactions off head, say at the end of trading period. A system of maintaining a record of the business transactions is normally employed depending on the volume of operations of the SME. A business should keep track of its expenses, sales, purchases, payments and other transactions as they take place. The level of financial literacy of the business person would dictate whether the records are kept on double entry, single entry or incomplete records. Effective implementations of financial literacy skills lead to improvement in business performance due to improved ability to track business events from the record system (Siekei, et al. 2013). The essence of maintaining proper records is to enable the business to determine its profits at the end of the year. Proper records also assist in obtaining credit facilities from financial institutions and other suppliers of goods. It is also necessary for purposes of meeting tax requirements. Proper record keeping is important in keeping track of the assets of the business. This is normally realized by maintaining an asset register. With advancement in technology maintenance of computerized accounts is possible. By keeping a record of business transactions during the year, the business is able to determine its performance as measured by the level of profitability. This is attained through preparation of an income statement.

2.5 Credit management

The major barrier affecting rapid development of the SMEs sector is the shortage of both debt and equity financing (Idowu, 2010). SMEs have limited access to capital markets given their size and nature of operations. The firms therefore have to rely on borrowings from financial institutions as well as profits ploughed back in financing its operations as well as for expansion. The other source of financing the inventory could be through trade credit. Generally there is a positive relationship between the efficient management of cash flow (the cash conversion cycle) and working capital, and the firm's profitability (Yazdanfar & Ohman, 2014). A firm that manages its working capital more efficiently is likely to increase its profitability. Credit obtained from whichever source normally has a price. Financial institutions offer loans at varying interest rates. The business person with sound credit management skills is required to compare the various credit facilities available and select one with lowest interest. High interest rates reduce profitability of the firm. Secondly the entrepreneur should be aware of the risks involved in delayed repayment of loans and default. Delayed repayments would normally attract penalties which further reduce the profits of the firm. In addition default in repayment of a loan may lead to attachment of the firm's assets thereby disrupting operations. Trade credit from suppliers should also be utilized with care to ensure that the firm reaps maximum benefits. This is because while the business may be able to obtain goods on credit, it may lose the benefits of cash payment like cash discounts. Again delay in paying the suppliers may strain relations. In such a situation the suppliers may decline to supply goods in the future leading to stock outs. Such a situation would lead to low sales as well as customer dissatisfaction hence less profit. However, it has been noted by various researchers that in many developing economies the use of formal accounting systems, credit management and cash flow monitoring is largely ad hoc and informal in nature (Orobia et al., 2013; Mungal & Garbharran, 2014). This type of poor practice in financial management has

been attributed to owner-managers having insufficient skills and knowledge of financial accounting controls (Uwonda et al., 2013). This typically results in these SMEs experiencing cash flow and liquidity problems with high levels of bad and doubtful debts (Abanis et al., 2013).

2.6 Tax Compliance

In many developing economies it is not mandatory for SMEs to keep financial records and as a result the owner-managers fail to do so, often avoiding the need to pay taxes at the same time (Amoako, 2013). In Kenya businesses are required to comply with the various tax requirements. Those dealing in vatable commodities are required to file VAT returns every month. Firms with employees are required to submit PAYE deducted on the employees salary. At the end of every year, the firm is required to file returns regarding profits generated during the year for purposes of determining tax payable. Failure to comply with any tax provision attracts penalty which impacts negatively on the performance of the firm. A firms assets may be attached to pay due taxes. This would greatly interrupt the operations of the firm leading to reduced profitability.

2.7 Performance

Performance is commonly employed as an index of a firm's health over a given period (Eniola & Entebang, 2015). This puts performance as one of the key issues in assessing the success of SMEs. Performance encompasses various meanings, including growth, survival, success and competitiveness. Performance can be characterized as the firm's ability to create acceptable outcomes and actions (Eniola & Entebang, 2015). Performance can be measured in terms of profitability, growth in sales and number of employees.

3.0 Methodology

The study adopted a descriptive survey research design. The target population comprised of all the SMEs in Butere Sub county totaling to 3,916. A sample of 390 was selected. Stratified random sampling was used to pick the respondents. Data analysis was done using a regression equation of the form $Y=\beta_0+ \beta_1X_1+ \beta_2X_2 +\beta_3X_3+ \beta_4X_4 + \varepsilon$ where X_1= budgeting skills, X_2= record keeping skills, X_3= credit management skills and X_4= tax compliance skills.

4.0 Findings

The following findings were identified by the study.

4.1 Budgeting Skills

From the study it was found that the ability of the business person to prepare cash budgets helps in meeting liabilities as they fall due with a mean of 4.6325 and a standard deviation of 0.5463. Ability to meet the liabilities especially with regard to suppliers ensures steady flow of supplies thereby leading to growth in sales. The respondents were of the opinion that preparation of cash budgets positively affects profitability of the business as indicated by a mean of 4.0922 and a standard deviation of 0.5463. This was attributed to the fact that proper cash planning will ensure timely settlement of liabilities including purchases, hence continued supply. On whether ability to prepare sales budgets helps in meeting sales demand, the respondents were in agreement with a mean of 4.5576 and a standard deviation of 0.3672. Proper sales forecast guarantees steady flow of goods to customers. The study also found out that preparation of sales budgets contributed to increase in sales with a mean of 4.000 and no standard deviation. Steady flow of goods ensures that all customer needs are met hence maximizing sales.

Table 1: Aspects of budgeting skills

Aspects of budgeting skills	Mean	Std. Deviation
Does the ability to prepare cash budgets help in meeting liabilities as they fall due	4.6325	0.5463
Has the preparation of cash budgets positively affected profitability	4.0922	0.6534
Does the ability to prepare sales budgets help in meeting sales demands	4.5576	0.3672
Has the preparation of sales budgets contributed to increase in sales	4.0000	0.0000

4.2 Record Keeping Skills

It was found that ability of the respondent to maintain proper record of daily sales leads to growth in sales with a mean of 4.5000 and a standard deviation of 0.5637. Proper recording ensures more accurate prediction of demand hence increase in sales. The study also established that ability to track transactions with the bank positively affected the relationship with the financiers with a mean of 4.8333 and standard deviation of 0.4672. Proper bank records could lead to positive credit rating. From the study it was found that keeping of proper expense records led to greater profitability with a mean of 4.1247 and a standard deviation of 0.6453. This was attributed to ability to track expenses hence reduce unnecessary waste. Lastly it was established that proper record keeping of purchases led to enhanced profitability with a mean of 4.6895 and a standard deviation of 0.5778. Proper record of purchases ensures timely payment of suppliers, steady flow of inventory. This ensures that the business does not run out stock, thereby meeting customer demand.

Table 2: Aspects of record keeping skills

Aspects of record keeping skills	Mean	Std. Deviation
Does ability to record daily sales lead to growth in sales	4.5000	0.5637
Does ability to maintain bank records affect relationship with financiers	4.8333	0.4672
Does maintenance of proper record of expenses lead to greater profitability	4.1247	0.6453
Does maintenance of proper record of purchases lead to enhanced profitability	4.6895	0.5778

4.3 Credit Management Skills

The findings of the study indicate that knowledge on loans and other credit facilities influences liquidity of the business with a mean of 4.5200 and a standard deviation of 0.4563. This was attributed to the fact that the business person with such knowledge can easily access credit. Availability of funds ensures that the business can meet its needs as the fall due. Similarly the study found out that knowledge on interest rates affected the cost of funds with a mean of 4.3874 and standard deviation of 0.5556. Knowledge on interest rates enables the business person to go for the cheapest option thereby reducing costs hence greater profitability. On loan repayment and effects of default, the respondents agreed that it affects cost of borrowing with a mean of 4.5674 and a standard deviation of 0.6554. Default in repayment leads to poor credit rating meaning that one can only obtain future credit at higher interest rates. Higher interest rates eat into profits of the business. Lastly the study established that level of indebtedness affects overall liquidity with a mean of 4.4555 and standard deviation of 0.3563. High levels of debt lead to eventual high levels of cash outflow in form of repayments. This may affect ability of the business to meet its other liabilities as they fall due.

Table 3: Aspects of credit management skills

Aspects of credit management skills	Mean	Std. Deviation
Does knowledge on loans and other credit offers affect liquidity	4.5200	0.4563
Does knowledge on interest rates affect the cost of funds	4.3874	0.5556
Does knowledge on loan repayments and effects of default affect cost of borrowing	4.5674	0.6554
Does level of indebtedness affect overall liquidity	4.4555	0.3563

4.4 Tax Compliance Skills

The study established that prompt filing of PAYE returns ensures avoidance of penalties with a mean of 4.0122 and no standard deviation. Avoiding penalties reduces cost of doing business hence greater profitability. Similarly the respondents indicated that proper maintenance of VAT accounts leads to greater profitability with a mean of 4.6553 and standard deviation of 0.4578. This was attributed to the

fact that such business people can deduct input tax from output tax hence obtaining a lower net sales figure. Secondly in case of excess input tax, they can claim a refund. Lastly timely filing of income tax returns was found to lead to avoidance of penalties with the responses giving a mean of 4.5567 and standard deviation of 0.6653.

Table 4: Aspects of Tax compliance skills

Aspects of tax compliance skills	Mean	Std. Deviation
Has prompt filing of PAYE returns led to avoidance of penalties	4.0122	0.0000
Does proper maintenance of VAT accounts lead to greater profitability	4.6553	0.4578
Is timely filing of Income tax returns contributing to avoidance of penalties	4.5567	0.6654

4.5 Regression Model

A multiple regression analysis was conducted to determine how the dependent variable (performance) was influenced by the independent variables (budgeting, record keeping, credit management and tax compliance). The following was the output

Table 5: Model Summary

Model	R	R Square	Adjusted R Square	Standard Error of Estimate
1	0.946	0.865	0.859	0.64657

Predictors: Budgeting skills, Record keeping skills, Credit management skills and Tax compliance skills.

From the model a change in performance is explained 85.9% by a combined change in budgeting, record keeping, credit management and tax compliance. The remaining 14.1% is explained by other factors not in the model
.

Table 6: Coefficient of Determination

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig
	B	Std. Error	Beta		
Constant	0.756	0.165		5.653	0.000
Budgeting skills	0.564	0.065	0.567	6.675	0.034
Record keeping skills	0.453	0.078	0.453	3.459	0.016
Credit management skills	0.378	0.067	0.386	3.654	0.025
Tax compliance skills	0.201	0.054	0.325	2.875	0.022

From the output generated, the regression equation $Y=\beta_0+ \beta_1X_1+ \beta_2X_2 +\beta_3X_3+ \beta_4X_4 + \varepsilon$ becomes $Y=0.756+ 0.564X_1+ 0.453X_2 + 0.378X_3+ 0.201X_4+ 0.165$. The regression equation shows that if all the independent variables are put into consideration, then performance of the SME is 0.756.

However, taking all the independent variables at zero, then a unit increase in budgeting skills will lead to 0.564 increases in performance. Similarly a unit increase in book keeping skills will lead to 0.453 increases in performance. Again a unit increase in credit management skills will increase performance by 0.378 and lastly a unit increase in tax compliance skills will lead to increase in performance by 0.201. This indicates that budgeting skills has the greatest impact on performance of SMEs while tax compliance skills has the least impact.

At 5% level of significance and 95% level of confidence, then budgeting skills, book keeping skills, credit management skills and tax compliance skills are significant in explaining the relationship between financial literacy and the performance of SMEs in Kenya. This is justified since their levels of significance are below the base significance level of 0.05

5.1 Conclusions

The findings of the study indicate that the performance of SMEs is greatly affected by the combined effect of budgeting skills, record keeping skills, credit management skills and tax compliance skills. On average, budgeting skills have the greatest impact on performance while tax compliance skills have the least impact. Financial literacy is therefore a significant factor in the success of SMEs.

5.2 Recommendations

Given the significance of financial literacy on performance of SMEs, it is important for the business people to acquire basic skills in the identified areas. The government should partner with non-governmental entities to empower the business people with the relevant financial literacy skills in order to spur economic growth.

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